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SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP

1440 NEW YORK AVENUE, N W

WASHINGTON, D C 20005-2111

TEL 12021 371 7000

FAX 12021 393-5760

http //www skadden cum

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(202) 371-7200
DIRECT FAX
(202) 371-7475
EMAIL ADDRESS
JQUALE@SKADDEN.COM

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Marlene Dortch
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Fcderal Communications Commission
445 12th Street. S.W.
Washington, D.C. 20554

RE: MB Docket No. 02-277, MM Docket No. 01-235,
MM Docket No. 01-317, MM Docket No. 00-244

Dear Ms. Donch:

Enclosed for inclusion in the record of the above-captioned proceedings. please find a copy of Professor Michael Katz's white paper entitled *Old Rules and New Rivals: An Examination of Broadcast Television Regulation and Competition* (September 1999), which originally was submitted to the Commission on November 18, 1999.

In the white paper, Dr. Katz, former Chief Economist of the Commission, determined that broadcasters face far more competition for advertising dollars, programming and viewers than they did when the Commission's ownership rules first were put into place. He concluded that the ownership rules undermine broadcasters' competitive position and no longer serve the public interest. By reducing the ability of the broadcast television industry to compete against the growing number of video outlets: the rules lower the economic welfare of both viewers arid advertisers.

If you have any questions regarding this matter, please contact the undersigned.

Respectfully submitted,

J. C. Quale

John C. Quale

Enclosures

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cc: Ken Fcrrce, Media Bureau (via email)
Paul Gallant, Media Bureau (via email)
Susan M. Eid, Legal Advisor to Chainnan Powell (via email)
Stacy Robinson, Legal Advisor to Commissioner Abernathy (via email)
Alex Johns, Legal Advisor to Commissioner Copps (via email)
Catherine Crutclier Bohigian, Legal Advisor Lo Commission Martin (via email)
Sarah Whitesell. Legal Advisor to Cornmission Adelstein (via email)

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OLD RULES AND NEW RIVALS: AN EXAMINATION OF BROADCAST TELEVISION REGULATION AND COMPETITION

Michael L. Katz

September 1999

This white paper was commissioned by ABC, CBS, and Fox.
Research assistance was provided by Charles River Associates, Inc.

EXECUTIVE SUMMARY

Over-the-air television is subject to numerous regulations that severely limit the ability of national networks and local stations to structure their operations in the ways that best serve their business objectives. Many of these rules were adopted half a century ago and **are** predicated on a lack of competition in broadcasting. Despite the dramatic increase in competition and the sweeping changes taking place both within the television industry and throughout the broader commercial environment in which this industry operates, regulatory reform has been slow and far too limited. Consequently, the current regulatory regime fails to reflect the new economic realities.

The national multiple ownership rule, which limits the ability of a single entity to own television stations on a nationwide basis, is a prime example of **a** regulation that is no longer justified in today's economic environment. Public interest analysis clearly demonstrates that the rule should be eliminated immediately. Inefficient rules like this one reduce the incentives to invest in non-subscription over-the-air television. They also reduce the ability of the broadcast television industry to compete against the growing number of outlets for video programming. These effects of regulation lower the cconnmic wcitare of hoth viewers and advertisers.

In 1996, Congress instructed the Federal Communications Commission to repeal or modify rules that no longer serve the public interest. Three years later, while the industry keeps changing, most of these rules have not. The perpetuation of outdated rrgulations is not only unnecessary; it can harm competition, diversity, and the public interest. The Commission should respond to Congress' mandate by seriously examining the current regulatory regime and by taking immediate action to revise or eliminate rules as appropriate.

*****

Many of the regulations that still govern the broadcast television industry were adopted based on marketplace analyses conducted in the 1940s and 1950s, when television was in its infancy. During much of this period, there were only two television networks and most communities had few local stations. There were no cable systems.

There was no such thing as satellite transmission. let alone direct-to-home satellite video. Video cassette recorders and video games did not yet exist. And not even academics were thinking of the Internet. In this environment, rules restricting the ownership of broadcast networks. stations, and certain non-broadcast media properties, and rules constraining the contractual relationships between television networks and their affiliated stations,.were deemed necessary to restrain the exercise of network market power and to promote competition and diversity.

Clearly. we live in a very different world today. Network "dominance" is a thing of the past. Revolutionary changes in technology and competition have fundamentally altered the competitive position of broadcast stations and networks, and have introduced numcrour new competitors to the marketplace.

Today. there are more broadcast television ***networks*** than there were commercial television *stations* when some of the rules were adopted. In addition to a larger number of networks, stations have many non-network sources of programming. Most households today arc located in markets served by 11 or more television stations. Between cable and satellite. almost every household in the U.S. has the option of purchasing multi-channel videv programming service. typically offering dozens or even hundreds of channels. Approximately 78 percent of television households subscribe to some form of multi-channel video programming service. Cable's combined subscription and advertising revenues exceed those of the broadcast networks. VCRs and video games are ubiquitous. And the rise of the Internet is one of the biggest economic and social developments of the past 50 years.

As a result of these dramatic changes. viewers, advertisers, program suppliers. networks. and stations have a large and growing variety of options available to them that were not available in the past. The existence of these options has sever;:', [illegible] implications for the regulation of television broadcasting:

First. bccausc broadcasters face much greater competition than ever before, there is no longer a need for a comprehensive set of regulations to protect viewers and advertisers from the exercise of network or station market power. Market forces. coupled with antitrust enforcement. will generally be sufficient to protect the public interest.

Second, because broadcasters have alternative channels for investment and growth, station and network owners have incentives to direct their creative and investment efforts elsewhere if their ability to engage in non-subscription, over-the-air broadcasting is artificially constrained by regulation. By reducing the economic opportunities and returns in broadcasting, regulation distorts investment decisions and drives broadcasters to direct more of their resources away from over-the-air broadcasting and toward cable and other distribution outlets.

Third, because local stations have an increased number of alternatives to affiliating with any given network, there is no need for a comprehensive set of regulations to protect stations from the exercise of network market power.

The national multiple ownership rule, under which a single entity cannot control television stations whose combined coverage exceeds 35 percent of U.S. television households, serves as an instructive example of the significance of these changes for the formulation of appropriate public policy. While the rule was originally adopted to promote the goals of competition and diversity. today it has no public interest justification. This conclusion follows from two central findings established in the paper.

One, *there is no evidence that the national station ownership cap serves any policy goal.* The available data and economic analyses support the conclusion that:

- Elimination of the cap would not threaten competition and indeed can be expected to strengthen broadcasters as competitors;
- Elimination of the cap would not affect diversity;
- The cap does not promote minority ownership; and
- Owners whose station groups have broad national audience reaches are equally if not more committed to localism than are owners of single stations or owners whose station groups reach smaller percentages of U.S. households.

'Two. *while the rule has no public interest benefits, the rule raises costs, leads to a less efficient organization of the industry, and therefore reduce,,program quality and raises the cost of advertising.* More specifically, the rule:

- Limits the realization of economies of scale and scope associated with common ownership of multiple stations. thus raising costs and reducing the incentives to invest in over-the-air television;

- Blocks the expansion of particularly well-run station groups. thus artificially raising costs and denying viewers and advertisers the benefits that would come from station management by owners who are especially able to serve viewer and advertiser interests: and

- Limits the ability of the broadcast networks to own stations, an arrangement which would otherwise improve the coordination between the networks and the stations that carry their programming. Restrictions on station ownership thus limit the returns and increase the risks **of** network investments in high-quality and innovative programming. Consequently, the national ownership cap reduces the networks' incentives to make such investments and ultimately diminishes the quality and diversity of programming.

In shun. ***this rule now harms the public interest rather than protects it.***

The Commission itself has repeatedly recognized over the past 15 years that limitations on national station ownership are arbitrary and unnecessary. In fact, in 1984 the Commission decided to sunset the rule completely by 1990. but Congressional opposition forced the Commission to abandon the planned sunset. Subsequently, the Commission has acknowledged that elimination of the rule would threaten neither competition nor diversity and would lead to efficiencies that would benefit the public. Yet. although careful and repeated analysis demonstrates a clear public interest in eliminating the multiple ownership cap immediately, the Commission continues to keep the rule in place.

The retention of the cap is particularly troubling (and puzzling) in the light of the Commission's recent decision to relax local ownership limits. This action only confirms that national ownership restrictions are arbitrary and unjustified. How can the Commission rationally conclude that a group owner at the current 35 percent national audience cap can purchase a *second* station in New York City without threatening competition or diversity, but cannot purchase a station in San Francisco, where it does not currently own one? How would ownership of the San Francisco station adversely affect either the diversity of programming available to New York viewers or the options available to advertisers seeking to reach New York consumers? Relaxation of the local ownership rule was clearly the correct decision, but it only serves to underscore the lack of any public interest basis for the national ownership cap.

This is not the first time that there has been concern that an inefficient regulatory regime for broadcast television is harming the public interest. Yet, over-the-air broadcasting has survived. So why is there any need to act now? The answer is twofold. First, over-the-air broadcast television faces greater competition than ever, and the effects of that competition on the nature of programming are being felt by broadcasters and viewers today. Networks are being outbid by cable networks for first-run broadcast rights to movies. And cable competition so eroded the audience for their weekday morning children's programming that the Fox network abandoned that daypart for children's television. Policy makers should he concerned when these and similar developments are the result of outmoded and unnecessary regulation rather than marketplace forces.

The second reason there is a public interest in acting now is that current policies are creating long-term costs by distorting investment incentives. Network owners have greater opportunities to redirect their investment efforts (both financial and creative) than ever before. And they are raking advantage of these opportunities. For example, ABC is launching a new soap opera channel. But instead of taking advantage of newly allocated digital broadcast spectrum to distribute the channel as a non-subscription over-the-air service. ABC is putting this new channel on cable. Similarly, when Fox decided to go into the national news business, it launched a cable network, FOX News Channel, rather than develop a national news programming service for its broadcast network.

By distorting economic returns in broadcasting, regulations inefficiently drive the networks to direct more of their financial and creative resources toward cable properties and other distribution platforms. That the networks are branching into other services is *not* !he problem — it is privately and socially valuable for them to make use of their skills and assets in these other services. Rather, the problem arises when regulatio: *distorts* these investment decisions. It is also important to recognize that, once broadcasters start investing in a particular direction, it may bc hard to reverse the effects of regulatory distortions. Consequently, the time to reform broadcast television regulation is now.

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I. INTRODUCTION

The over-the-air television industry is subject to numerous regulations that limit the ownership of broadcast networks, stations, and certain non-broadcast media properties. Other regulations constrain the contractual relationships between television networks and the stations that carry their programming. These regulations include the national multiple ownership cap, various local- and cross-ownership rules, and the network-affiliate rules.[1] By limiting the networks' and local broadcasters' abilities to structure their operations in the ways that best serve their business objectives, these regulations reduce the incentives to invest in non-subscription broadcast television.

These regulations were adopted decades ago, at a time when the broadcast television industry was much more concentrated than it is today. and the rules were primarily seen as necessary to restrain the exercise of network market power and to promote diversity. Arguably. when the regulations were adopted, the inefficiencies they created were more than offset hy the public interest benefits they produced. In the past. non-subscription broadcasting was the only (video) game in town, for viewers. advertisers, and the broadcasters themselves. Today, however, viewers, advertisers, stations, and networks have a large and increasing variety of options available to them.

The increases in options have several fundamental implications. The increase in viewer options means that broadcasters today face much greater competition for viewers than ever before. This increase in viewer options goes hand in hand with an increase in

[1] This uhite paprr does not address the assortment of rules and policies addressing broadcast licensee obligations to serve the public interest. including affirmative content requirements as well as content prohibitions. As will becnme clear from the analysis below. the rules ihar are the subject of this white paper play no useful role in enforcing licensee obligaiions.

advertiser options. Again, the result is that broadcasters face greater competition than ever. Network dominance is a thing of the past. The implication for regulation is clear the perpetuation of a comprehensive set of broadcast regulations to protect consumers and advertisers from the exercise of network market power is unnecessary. Marker forces. coupled with antitrust enforcement, generally will be enough. Moreover, as demonstrated by the analysis below, at least some current regulations actually harm consumers and advertisers.

The increases in options for broadcast networks and stations also have important consequences. The increased options for networks and stations create alternative channels for investment and growth. Here too, the implications for regulation are clear. One. there is no longer a need for a comprehensive set of broadcast regulations to protect stations from the exercise of network market power; competition has eliminated any network dominance, Two, station and network owners have incentives to direct their creative and investment efforts elsewhere if their abilities to engage in non-subscription, over-the-air broadcasting arc artificially constrained by regulation.

The tremendous economic changes that have taken place since the various rules were pur in place alter the costs and benefits of regulations governing the ownership structure of—and various economic relationships within—the broadcast industry. Thus, any discussion of public policy toward broadcasting must be well grounded in the facts of the competitive environment. After briefl reviewing the regulatory environment. the first part of this paper documents the sweeping competitive changes that continue io iake place in broadcasting.

The second part of this white paper demonstrates the importance of these changes to the formulation of appropriate public policies by examining the national multiple ownership rule, which limits the extent to which a single entity can own broadcast stations with broad aggregate coverage. A **full** analysis of any regulation must examine the rationale for the regulation, whether the regulation promotes policy makers' stated goals, and what other effects the regulation has on economic efficiency and consumer welfare. **A** review *of* industry developments demonstrates that the original rationale for the rule no longer is valid in today's competitive environment. Moreover, there is no evidence that the rule serves its stated goals of promoting competition, diversity, localism, and minority participation in media markets. Further, the rule imposes efficiency costs on the U.S. economy. Thus, there is a clear public interest in repealing the national multiple ownership rule.

It is clear that the national multiple ownership rule no longer serves the public interest. This analysis strongly suggests that other broadcast rules predicated on the lack of competition in broadcasting are in similar need of elimination or substantial revision to reflect the new economic rcalities. While there has been much talk over the past several decades *of* sweeping reform of broadcast regulations, the actual reforms have been limited and piecemeal. Comprehensive reform is needed. And, for the reasons discussed in the concluding section of this whire paper, that reform is needed now.

II. A BRIEF HISTORY OF REGULATION

The rules governing hroadcast ownership and network-affiliate relations are based on a regulatory framework adopted over 50 years ago. Figure 1 presents a summary timeline.

At least two points jump out from this summary time line. One is that the rules were put into place as the result of analyses conducted in the 1940s and 1950s. Indeed, many of the rules had been designed for radio and were applied to the nascent television industry with little analysis. At the time several of these rules were adopted, there were two broadcast television networks and most cities had few local stations. There were no cable systems. There was no such thing as a satellite. let alone direct-to-the-home satellite video. Video cassette recorders and video games did not yet exist.

Clearly, we live in a very different world today. The television industry is vastly more competitive than it was when the regulations were adopted. Sweeping changes have occurred both within the over-the-air terrestrial broadcasting industry and throughout the broader commercial environment in which this industry operates. Today, there are seven mainstream commercial broadcast networks as well as other, more narrowly targeted networks.[2] Most households live in television market served by 11 or more stations each. **Over** 90 percent of American homes are passed by cable, and over 65 subscribe. There are over 170 cable networks. Cable's combined subscription revenues exceed those of the networks. Satellite-delivered services offering hundreds of channels are offered to almost every corner of the U.S., and millions

---

ABC, CBS, Fox, NBC, Pax TV, UPN, and The WB. There are also specialized networks, such as Univision and Telemundo (which serve Spanish speaking viewers). In addition, there are regional broadcast networks, such as Raycom, which generally are devoted to sports programming.

FIGURE 1
A REGULATORY TIMELINE

1940s: Report on Chain Broadcasting[1] expresses concerns over radio network dominance. Rules originally adopted for radio and extended to television without an extensive analysis of their applicability.

1950s: Barrow Report[2] expresses concern over network dominance and Commission adopts additional rules in response.

1970s: Federal Communications Cornmission adopts cross-ownership restrictions.

1980s: Network Inquiry Report[3] finds that many rules hurt competition, but Commission does not act. Commission finds that national ownership cap serves little purpose and partially relaxes the rule.

1990s: Commission repeals Financial Interest and Syndication Rules and Prime Time Access Rule. It also suggests that national ownership rule is outdated and has little justification, but seeks further comment. Tclecom Act of 1996 implements some reforms and calls for biennial review. Commission modifies local ownership rule.

[1] *Report on Chain Broadcasting*, Docket No. 5060, (May 1941).

[2] *Network Broadcasting. Report of the Network Study Stuff to the Network Study Committee* (Oct 1957) reprinted in Report of the House Committee on Interstate and Foreign Commerce. H.R. Rep. No. 1297, 85th Congress. 2nd Sess. (1958).

[3] Network Inquiry Special St[illegible] *ion Networks: Entry, Jurisdiction, Ownership and Regulation,* [illegible] ber 1980).

of households subscribe to these services. VCRs and video games are ubiquitous. And the rise of the Internet is one of the biggest economic and social developments of the past SO years. Figure 2 highlights some of the changes that have occurred.

The changes in television broadcasting's competitive environment lead to the second observation about Figure I. For the last two decades, the staff and Commissioners of the Federal Communications Commission (the Commission) have expressed serious reservations about many of the rules. Yet, the Commission has been slow to refonn these policies. Despite the tremendous increase in competition for viewers, advertising, station-network affiliations, and programming, a wide range of rules predicated on the absence of competition remain. Some of these rules are listed in Figure 3, which also indicates the last dale at which the rules were subject to major revision.

In many ways it is surprising rhat broadcast television regulations have changed so little in comparison with the economic environment. Jn theory, one possibility is that the rules continue to serve the public interest. Thus, before examining current industry trends in detail, it is useful to review the policy concerns that have been raised as justifications for these regulations.

The overall concern motivating adoption of the rules was that television networks and multiple owners had too much economic power and that the exercise of this power led to ill effects along several different dimensions:

Competition. There is a public interest in competition, which is widely recognized as promoting lower prices. higher quality, and innovation that can raise quality and lower costs. Competition takes many forms. including competition for viewers, competition for advertisers, and competition to obtain programming.

FIGURE 2
COMPETITION: THEN AND NOW

THEN	NOW
Three networks	Seven+ broadcast networks
Few broadcast stations per market.	More than half of households live in markets with 11 or more stations.
No cable.	Over 65% of households subscribe to cable.
No satellites	Satellites offer hundreds of channels to almost every household.
No Internet	New media are driving the economy.

FIGURE 3
SOME OF THE RULES RESTRICTING THE OWNERSHIP AND OPERATION OF BROADCAST NETWORKS

1946: Right to Reject Rule: requires affiliation contracts to allow stations to reject network programming ostensibly to serve local viewer interests.

1946: Network Control of Station Advertising Rates Rule: prohibits agreements by which a network can influence or control the rates its affiliates set for rhe sale of their non-network advertising time.

1959: Network Advertising Representation Rule: prohibits broadcast television affiliates that are not owned by their networks from being represented by their networks for the sale of non-network advertising time.

1970: Cable/Television Cross-Ownership Rule: effectively prohihits common ownership of a broadcast television station and cable system in the same market.

1972: Daily Newspaper/Broadcast Cross-Ownership Rule: prohibits common ownership of a broadcast station and daily newspaper in the same locale.

1996: Dual Network Rule: does not allow an entity lo maintain two or more broadcast networks if such dual or multiple networks are composed of (1) two or more of ABC, CBS. Fox, and NBC, or *(2)* any of the four major networks and one of The WB and UPN. Based on 1941 radio rules.

1996: National Television Ownership Rule: sets a 35 percent national audience reach cap on television station ownership. Is a relaxed version of policies adopted in the 1940s.

1999: Television Duopoly Rule: a party may not own, operate or control two or more broadcast television stations with overlapping Grade **B** signal contours within a single Nielsen Designated Market Area (DMA). except that an owner can acquire a second station if at least eight full-power independently owned television stations will remain after the merger.[1]

[1] There is also a requirement that ai least one of the stations under common ownership not be among the top four-ranked stations in the markei baaed on audience share at rhe time of the acquisition

- **Diversity.** Historically, public policy makers have expressed the desire to have a diverse set of opinions and viewpoints reflected in public media. The concept of diversity can take many forms, including source diversity, outlet diversity, and viewpoint or content diversity.

- **Localism.** Policymakers have also expressed the view that there should be outlets for content that is of particular local interest.

- **Minority Ownership.** In recent years, many policy makers have expressed concern about the extent of minority ownership of firms in telecommunications industries in general and the television industry in particular. While minority ownership can be viewed as a type of diversity concern, it goes beyond the standard notion of diversity by focusing on a particular group, rather than being concerned solely with numerical diversity.

As will become evident from an analysis of industry structure and trends, the economic power of broadcast networks and local stations has greatly diminished over the past couple of decades. There is both greater competition within the broadcast industry and greater cornpetition from other media. This indisputable increase in competition requires a fundainental reassessment of whether continued regulatory intervention is necessary to protect or promote competition, diversity, and localism.’ The increase in competition also requires an assessment of whether current regulations harm the public interest hy distorting the organization of, and investment in, non-subscription broadcast television.